ANALYSIS BEYOND CONSENSUS

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Ranbaxy Laboratories

Annual Report Analysis | July 08, 2008

EdelRank
5

EdelRank: Annual report ranking for best accounting and disclosure practices (on a scale of 1-10 from best to worst): Refer Annexure-A for details.

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Market Data

52-week range (INR):	613 / 299
Share in issue (mn):	373.2
M cap (INR bn/USD mn):	189/4,363
Avg. Daily vol. BSE ('000):	2,239.2

Share Holding Pattern (%)

Promoters	:	34.8
MFs, FIs & Banks	:	23.3
FIIs	:	17.9
Others	:	23.9

High ROE due to zero coupon FCCBs and forex loan revaluation unlikely to sustain

- ROE (adjusted) at 26.5%, despite low return on net operating assets (RNOA), at 9.5% (ROE analyser analyses the difference).

- Exchange gain on loans (INR 3,071 mn) contributed 30.8% to the reported profit before tax. It appears that the company is taking exchange rate risk to reduce borrowing cost. Unhedged loans as on December 31, 2007, were at INR 25,790 mn (INR depreciated 9.7% against USD since December 2007). **INR depreciation could reverse benefits and increase borrowing costs significantly.**

- Pursuant to the acquisition by Daiichi Sankyo, the foreign currency convertible bond (FCCB) will be convertible at a price of INR 540/share, instead of INR 716.3 per share, which will significantly reduce leverage benefits, and hence, ROE. Also, the exchange gain booked earlier will not be realized, since bonds will be convertible at a fixed exchange rate of INR 44.15/USD.

Compliance with logical accounting to significant impact reported financials

- The impact of compliance with more logical global accounting practices is likely to result in reduction of basic EPS by 12.6% and ROE by 7%. ICAI has issued a white paper on convergence of IGAAP with IFRS, and has indicated to fully adopt IFRS from the financial year, commencing from April 01, 2011.

- Accounting choice for zero coupon FCCBs has kept the financing cost off income statement, and resulted in lower reporting of finance cost and higher net profits.

Financial statement analysis and key extracts from MD&A

- Goodwill, at INR 19,298 mn, is at 69% of the reported net worth, and 21% of the total assets of the company.

- Contingent liabilities, at INR 1,696 mn (INR 1,460 mn towards claims not acknowledged as debt and INR 234 mn towards indirect taxes), are ~6% of the reported net worth.

- Sundry debtors outstanding more than six months, at INR 1,581 mn (previous year: INR 1,675 mn), is ~ 5% of the reported net worth.

- Ranbaxy Laboratories completed the acquisition of Be-Tab Pharmaceuticals (Proprietary) and Be-Tab Investments (Proprietary) in South Africa, becoming the fifth-largest generic pharmaceutical company in the geography.

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FCCB contributes to high leverage

Loan revaluation caused negative borrowing cost

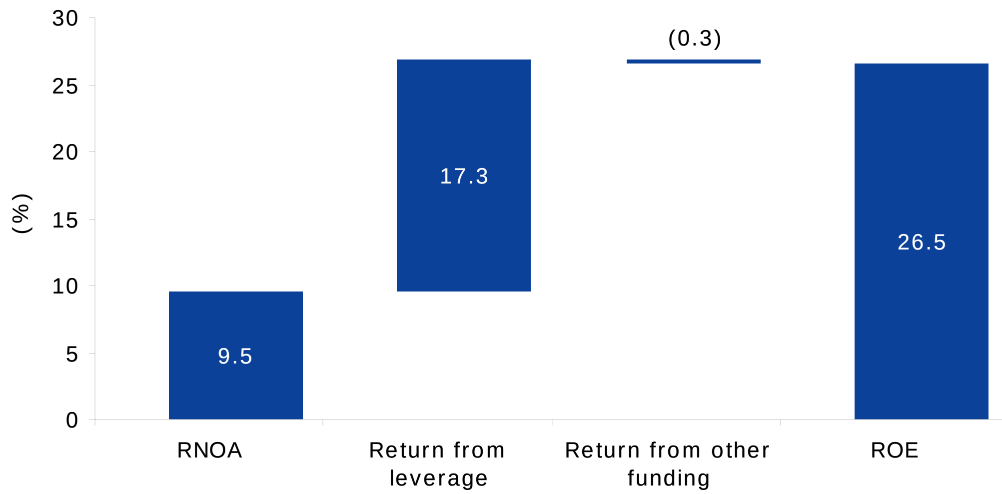
Profitability analysis (ROE analyser)

ROE analyser analyses the profitability on the scale of operating efficiency and capital allocation efficiency (detailed concept explained in Annexure B). We have analysed Ranbaxy's profitability for 2007, results, and key findings of which are given below:

ROE Analyser	CY07	CY07
A. Return on net operating assets (RNOA) (OPATO x NOPAT margin) (%)		**9.54**
OPATO (operating assets turnover) (x)	1.02	
NOPAT (net operating profit after tax) margin (%)	9.34	
B. Return from leverage (FLEV x spread) (%)		**17.28**
FLEV (financial leverage) (x)	1.37	
NBC (net borrowing cost) (%)	(3.11)	
Net financing spread (RNOA-NBC) (%)	12.64	
C. Return from other funding (%)		**(0.28)**
ROE derived (A+B+C) (%)		**26.54**

Source: Company annual report, Edelweiss research

ROE Tree



Source: Company annual report, Edelweiss research

Non-operating and accounting factors contributed significantly to ROE

High return from leverage contributed by:

1. High financing spread due to:
   - Zero coupon FCCBs.
   - Negative borrowing cost on account of exchange rate gains on loans. The company has reported INR 3,071 mn towards forex gains on loans (30.8% of PBT).
2. Multiplier effect of high leverage (1.4x).

ROE: Whether real and sustainable

- The advantage of low interest cost because of zero coupon FCCBs will be subdued on compliance with AS 30-31, which will require charge of redemption premium to profit and loss (P&L). This will result in narrowing of the financing spread (a major contributor to ROE).

- Even in the event of FCCB being converted into equity, which is the case now (pursuant to acquisition, FCCBs will be converted at reduced price of INR 540/share). The advantage of multiplier effect of high leverage to ROE will significantly narrow down.

- It appears that Ranbaxy is keeping forex loans unhedged, which may be a negative drag on its profitability in the event of INR depreciation. INR 25,790 mn of loans (including FCCB) were unhedged as on December 31, 2007 (Since December 31, 2007, the INR has depreciated against USD by ~9.7%). The exchange gains booked earlier on FCCB need to be reversed on conversion.

Based on the above analysis, we believe, the abnormally high ROE reported by Ranbaxy is unlikely to sustain and is likely to converge with RNOA.

Cash raised/generated from all sources utilised to pay dividends

Cash flow analysis (Refer Annexure-B for details)

(INR mn)

Reformulated cash flow	CY07	CY07
Net cash from operating activities (1)		**934**
Adjusted NOPAT #	6,387	
Less : Increase in adjusted NOA #	(5,453)	
Net cash from financing activities (2)		**2,603**
Adjusted net financing income #	549	
Add : Increase in net financing obligation #	2,054	
Net cash to share holders (3)		**(3,537)**
Increase in share capital	104	
Less : Dividend paid to shareholders including tax	(3,641)	

Source: Company annual report, Edelweiss research

Note: # Adjusted for direct debit into reserves

1. Cash from operating activities: Cash generated from operations less cash deployed into net operating assets (includes operating cash).
2. Cash from financing activities: Sum of net cash from debt financing and non-strategic investments (includes surplus cash).
3. Cash from/(to) shareholders: Sum of 1 and 2 represents net cash flow from/to shareholders (represents dividend/share buyback/share issuances).

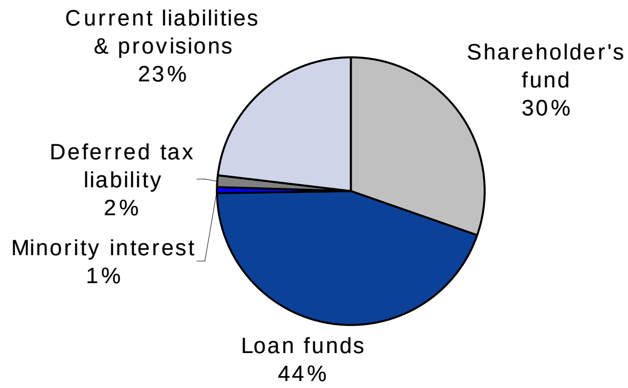
Takeaways from cash flow analysis:

- Operating activities have generated sufficient cash to finance incremental operating assets.
- Net cash inflow from financing activities at INR 2,603 mn.
- Net outflow to shareholders at INR 3,537 mn.

Balance sheet and income statement analysis

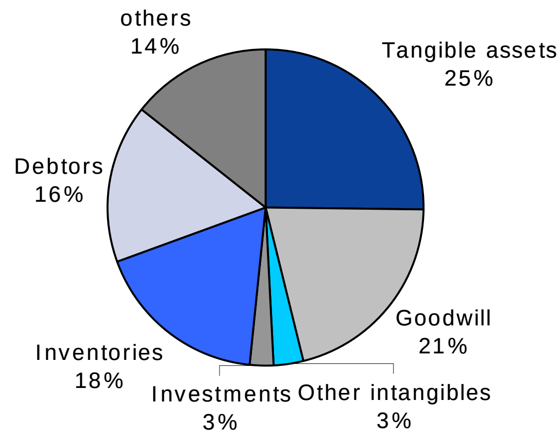
Loan funds major contributor: Majorly represented by quasi equity instruments FCCB

Sources of funds



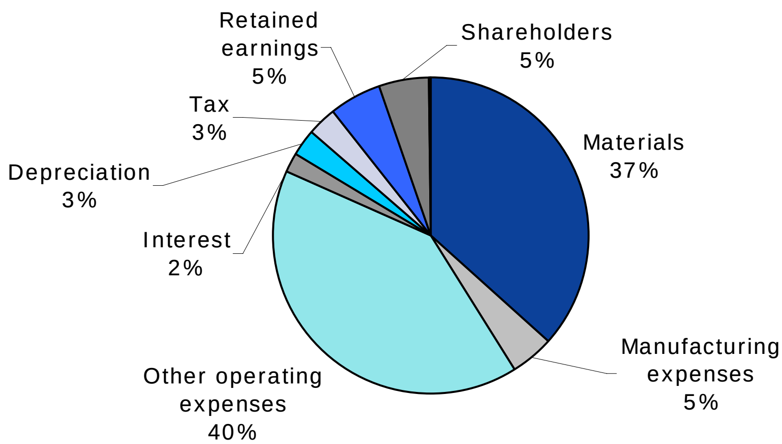
Goodwill and intangibles form significant proportion of total assets

Utilisation of funds



Favorable exchange rate movements and accounting choice on zero coupon FCCBs caused low interest cost, despite higher proportion of loan funds

Utilisation of income



Source: Company annual report, Edelweiss research

Accounting policy analysis

ICAI has issued a concept paper on convergence of accounting standards with IFRS and has indicated full adoption of IFRS from the financial year, commencing from April 01, 2011.

We have calculated the impact on reported financials of the company in light of more logical globally accepted practices (refer Annexure C for details).

The quantifiable impact of the above has been summarised below:

- Basic EPS will be reduced to INR 18.2 per share (12.6% lower) against the reported INR 20.8 per share.
- ROE will be reduced to 20.7% (25% lower) against the reported 27.6%.
- PAT will be reduced to INR 6,772 mn (12.6% lower) against the reported INR 7,745 mn.

Impact of adoption of more reasonable accounting **(INR mn except for calculation of EPS)**

S.No.	Particulars of the Issue	Reason	Impact on PAT	Impact on Equity	Impact on basic EPS
1	Issue expenses and redemption premium on FCCB amortized directly to share premium.	IFRS/AS 30/31 more logical	(656)	3,679	(1.8)
2	Stock option granted to employees accounted for using intrinsic value method.	IFRS/ US GAAP more logical	(286)	(286)	(0.8)
3	Goodwill recognition under business combination – definite life intangibles not recognized results in higher goodwill & lower amortization expense.	US GAAP more logical	(31)	(31)	(0.1)
4	Investment valuation done at lower of historical cost and market price.	IFRS/ AS 30/31 more	---	1,397	---
5	Defined benefit provident fund obligation not determined based on actuarial valuation.	AS 15 not complied	Note 1	Note 1	---
6	Work-in-progress inventory at cost up to stage of completion as against lower of cost or net realisable value.	AS 2 Not complied	Note 1	Note 1	---
7	Unrealized gains/losses not recognized on the foreign currency option contracts	IFRS/ AS 30/31 more logical	Note 1	Note 1	---
8	Excess of net assets over consideration paid under amalgamation recognised as capital reserve rather then reducing from the value of assets acquired	US GAAP more logical	Note 3	Note 4	---
	Total	**(A)**	**(972)**	**4,759**	(2.6)
	Reported Consolidated PAT, Equity and basic EPS	(B)	7,745	28,034	20.8
	Revised PAT , Equity and Basic EPS		6,772	32,793	18.2
	% Impact	(A)/(B)	(12.6)	17.0	(12.6)

Source: Edelweiss research

Note 1 – Due to unavailability of sufficient information, the impact is not quantifiable.

Note 2 – In our opinion, the company's PAT is likely to reduce; however, due to unavailability of adequate information, the impact is not quantifiable.

Note 3 – In our opinion, the company's PAT is likely to increase; however, due to unavailability of adequate information the impact is not quantifiable.

Note 4 – In our opinion, the company's net worth is likely to reduce; however, due to unavailability of adequate information, the impact is not quantifiable.

ANNEXURES

Annexure A – EdelRank

EdelRank is a framework that ranks companies objectively for compliance with accounting standards and disclosure requirements. The ranking is done based on percentage scoring achieved by the company for adhering to accounting standards and disclosure norms out of predefined score card.

Annexure B – ROE and cash flow analyzer

ROE analyser analyses the profitability on the scale of operating efficiency and capital allocation efficiency. While operating efficiency is a measure of how efficiently the company is making use of operating assets, capital efficiency is the measure of balance sheet efficiency.

The above analysis involves:

1. Dissection of profitability along two major drivers:

   a. Return from operating activities (RNOA: return on net operating assets).

   b. Return from financing activities (leveraging effect on ROE).

   ROE = Return from operating activities (RNOA) + Return from leverage

   Or

   ROE = Operating margin x Operating assets turnover + Leverage spread x Leverage multiplier

   Whereas:

   - RNOA = NOPAT/Average operating assets
   - Operating margin = NOPAT/Operating revenue
   - Operating assets turnover = Operating revenue/Average operating assets
   - Leverage spread = RNOA – Net borrowing cost
   - Leverage multiplier = Average net financial obligation/Average common shareholders' equity

2. Reformulation of balance sheet, wherein, we have regrouped assets and liabilities into operating and financing categories (against traditional current and non-current categorisation).

3. Reformulation of income statement, wherein, we have regrouped income and expenses into operating and financing activities.

Cash flow analyser:

Unlike traditional cash flow, reformulated cash flow (zero sum cash flow) clearly distinguishes cash generation/usage into three broad buckets:

1. Cash from operating activities: Cash generated from operations less cash deployed into net operating assets (includes operating cash).
2. Cash from financing activities: Sum of net cash from debt financing and financial assets (includes surplus cash).
3. Cash from equity financing: Sum of 1 and 2 represents net cash flow from/to shareholders (represents dividend/share buyback/share issuances).

Annexure C - Accounting policy analysis

ICAI has issued a concept paper on convergence of accounting standards with IFRS and has indicated full adoption of IFRS from the financial year, commencing from April 01, 2011. IASB and FASB are finalising a joint conceptual framework to make accounting more logical by adopting better practices either from IFRS or US GAAP.

We have recomputed the financials by:

(a) Applying more reasonable accounting treatment to the transaction, where no authoritative accounting standard is issued for that transaction.

(b) Applying the logical accounting standard in cases where a transaction is accounted by the company under any legal and regulatory requirement, and not as per existing accounting standards.

(c) Applying accounting principles prescribed by IFRS/US GAAP, where the accounting principles significantly differ from that of Indian Accounting Standards, and the treatment prescribed by IFRS/US GAAP is more logical. However, please note that these do not represent conversion of the financial statements in compliance with IFRS.

Issue expenses and redemption premium on FCCB and split accounting

- **Existing provision**

  The transaction cost, directly attributable to the issue of bonds/notes, is charged to the security premium account (i.e., net worth) as defined in Section 78 of the Companies Act, 1956.

  Premium payable on the redemption of bonds is treated differently by companies:

  a. Some companies charge it proportionately over the maturity period of the bond to the securities premium account in absence of any specific guidelines and accounting standard.

  b. Few companies charge redemption premium fully in the securities premium account in the year of issue.

  c. Most companies give no treatment for redemption premium.

  d. Very few companies charge redemption premium over the maturity period of the bond to P&L account.

- **Logical treatment as per IFRS / AS 30 / 31**

  IFRS and new AS 30 / 31 require the issuer to show the liability component and equity component separately on the balance sheet (split accounting). The liability component is measured on the basis of the present value of future cash flows discounted at the market interest rate for similar instruments, but without the conversion option. The difference between proceeds of bonds issue and the fair value of liability is assigned to the equity component.

  Redemption premium will be calculated on the liability portion and treated as an expense to be amortised over the life of the FCCB on YTM basis.

  Transaction costs (e.g., issue expenses) are allocated to the liability and equity components in proportion to the allocation of total proceeds of bonds; the portion allocated to liability component will be amortised over the life of the FCCB on YTM basis.

Stock option granted to employees

- **Existing provision**

According to the guidance note issued by ICAI on 'Accounting for share-based payments', the enterprise has an option to account for employee stock compensation based on either the 'fair value' method or 'intrinsic value' method. Intrinsic value is the amount by which the quoted market price of the underlying share, or its value determined by an independent valuer, exceeds the exercised price of option.

- **Logical treatment as per IFRS/ USGAAP**

Both IFRS and US GAAP prescribe the 'fair value' method of expense recognition for share-based payment to employees. An enterprise that grants stock options to its employees is required to measure their fair value using an option pricing model and recognise that cost over the vesting period of the option. The 'fair value' method will result in recognition of higher stock compensation expense.

Method of valuation of assets and liabilities acquired under business combination

- **Existing provision**

As required by AS 14 'Accounting for amalgamation', goodwill is being recognised in the consolidated statement on the basis of the excess of cost of acquisition over *the book value of net asset* acquired on the date of acquisition.

The goodwill recognised is not required to be amortised; instead it is tested for impairment at each balance sheet date.

- **More logical accounting treatment as prescribed by US GAAP**

As per US GAAP, the company has to recognise goodwill on the basis of the excess of cost of acquisition over *the fair value of the net assets* acquired on the date of acquisition. The company also needs to recognise the intangible assets that are not identified by the acquired company. Hence, the amount of goodwill recognised may reduce. An intangible asset with finite life identified has to be amortised over its useful life and an intangible asset with infinite useful life has to be tested for impairment.

Investment valuation

- **Existing provision**

In accordance with AS 13 'Accounting for investments', issued by ICAI, investments can be classified as current or long term. Current investments are carried at lower of cost and fair value determined on an individual investment basis. Long-term investments are carried at cost; however, provision for diminution in value, other than temporary, is made.

- **Logical accounting treatment as per IFRS/New AS 30/31**

According to IFRS, and recently issued AS 30 / 31, 'Financial Instrument–Recognition and measurement'/ 'Financial Instrument–Presentation', by ICAI, investment should be classified under three categories as fair value through profit or loss (FVTPL, held for trading), available for sale (AFS), and held to maturity (HTM).

At each balance sheet date investments are revalued.

1. FVTPL and AFS: At fair value.

2. HTM: At amortised cost using effective rate of interest.

Gains or loss at revaluation should be accounted in the financial statement as per guidelines given below:

1. FVTPL: Recognised in statement of P&L.

2. HTM: Amortisation of interest to be recognised in statement of P&L.

3. AFS: Accumulated in a separate equity account. The accumulated balance of equity account to be adjusted in the P&L statement in the year when the investment is disposed of.

Accounting for foreign exchange derivatives held for hedging

- **Existing provision**

  In accordance with AS 11, 'The effect of changes in foreign exchange rates', the amount recognised in P&L account is calculated as the product of:

  – The difference between spot exchange rate at the date of inception and on the last date of reporting period, and

  – Nominal value of forward exchange contracts to hedge the foreign currency risk of an underlying asset or liability.

  The premium or discount on such contracts is amortised as expense/income over the life of contract.

- **More logical accounting treatment as prescribed by IFRS / New AS 30/31**

  Both IFRS and the new AS 30/31 'Financial Instrument –Recognition and measurement' / 'Financial Instrument – Presentation', issued by ICAI, prescribe hedge accounting for the accounting treatment of derivatives designated as hedge. Hedge accounting recognises the offsetting effects on profit or loss of changes in fair values of the hedging instrument and the hedged item.

  There are different accounting treatments for the three types of hedge relationships:

  (a) Fair value hedge: The gain or loss from re-measuring the hedging instrument at fair value and on the hedged item attributable to the hedged risk is to be recognised in statement of profit and loss.

  (b) Cash flow hedge: The hedge of the exposure to variability in cash flows of the recognised asset or liability or a highly probable forecast transaction that is attributable to a particular risk and could affect profit or loss. The portion of gain or loss on the hedging instrument that is determined to be an effective hedge should be recognised directly in an appropriate equity account. That determined to be an ineffective hedge should be recognised in statement of P&L. The effective portion of the hedge is one in which the change in cash flow of the hedged item, which is attributable to the hedged risk, is offset by changes in cash flow of hedging instrument.

  (c) Hedge of net investment in foreign operations: The accounting prescribed for this is same as for cash flow hedge.

Capital reserve arising on amalgamation

- **Existing provision**

  AS 14 'Accounting for amalgamation' requires any excess amount of net assets acquired from transferor company over the consideration paid to be treated as capital reserve.

- **Logical accounting treatment as prescribed by US GAAP**

  As per US GAAP, the capital reserve (negative goodwill) arising on amalgamation is allocated as a pro-rate reduction from assets, except financial assets (other than investments), and other current assets.

  If any excess remains after reducing the carrying amounts of those assets to zero, then the same is recognised as extraordinary gains.

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